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THE EURO: IMPLICATIONS FOR LATIN AMERICA[1]

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Introduction

The creation of the Euro, in January 1999 to be completed by 2002 with the introduction of the actual Euro currency, is a landmark in European economic integration. It crowns a process that led from World War II via a range of narrow economic cooperation agreements to a customs union, the creation of an internal market and now a common central bank and irrevocably fixed exchange rates. And even these exchange rates are soon gone as national monies are phased out in 2002. Europe, from the protected and segmented markets of the 1950s, has succeeded in building an economic block of the importance of the US.

Table 1 Euroland and the US

	Euroland	US
Share of World GDP	25	28
Share of World Trade	17	14

The 11 members — core-Europe less Greece, the UK, Denmark and Sweden form this block. Most of these are likely to join before monetary union is complete in 2002. But in the meantime the underlying European Union (the expansion of the customs union) is expanding to the East and that may, later, create an extra round of accessions to the monetary union.

The institutions already operating or to come are the following:

- In capital markets all securities are denominated in Euros; specifically, public debts and stocks are denominated and traded in Euros.

- A common central bank and independent Central Bank has replaced the monetary policy functions of the national central banks; the latter, absurdly continue to exist, but without substantive functions. Importantly, the Council of Finance Ministers

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retains the prerogative to formulate exchange rate policy and thus has at least the potential of undermining central bank independence.

- Exchange rates among the 11 members are fixed permanently and enforced by the common central bank. National monies disappear latest at the beginning of 2002.

- The Waigel Pact—part of the convergence concessions to make monetary union palatable in Germany—severely limits budget deficits.

- The 1992 “internal market measures” opened cross border competition and deregulation to the point of effectively abolishing internal borders within the European Union. In fact, intra-European movements of goods and people proceed totally unhampered, as do services; borders no longer exist.

With the introduction of the *Euro* and European Monetary Union, it helps now to take stock of what has been accomplished and resolved and what important steps lie ahead:

- The claims of the great gains from transparency and the resulting competition and efficiency effects are by and large overstated. The Euro will not lead to great gains in competition and transparency: Exchange rates have been fixed in Europe for more than a decade (discounting Italy’s momentary departure; Everybody can divide by the exchange rate and any repeat purchaser surely will. Price discrepancies in Europe reflect two facts: first, all prices (like all politics) are local. There are price discrepancies within and across US cities, from wholesale to retail and across service add-ons. No surprise in this and it has nothing to do with one or many monies. Second, price discrepancies do have a lot to do with the limited competition at the retail level and above all with a long tradition of anti-competitive practices.

- The introduction of the Euro, and a decade of learning about the scope for independent monetary policy in institutionally weak economies in a world of intense speculative capital, offer a unique opportunity to Europe’s periphery. Joining the Euro by way of currency boards, rather than waiting a decade for formal membership, offers immediate gains in macroeconomic stability, reduced cost of capital and a far more rapid access road to becoming part of the core.

- The propaganda about the great gains from transparency and the resulting competition and efficiency effects is by and large nonsense. Everybody can divide by the exchange rate and any repeat purchaser surely will. Price discrepancies in Europe reflect two facts: first, all prices (like all politics) are local. There are price discrepancies within and across US cities, from wholesale to retail and across service add-ons. No surprise in this and it has nothing to do with one or many monies. It has a lot to do with the limited scope for competition at the retail level and with anti-competitive practices

- One great payoff on the Euro is the financial disarmament of the periphery—Italy and Spain, even France. The common money has made these regions safe for investors and that in turn is reflected in lower interest rates and higher growth; risk premia have been sharply compressed because they no longer have central banks or exchange rates to play with. Waigel-pact restrictions have further helped by stabilizing sovereign risk, adding on to the benefits of lower interest rates. Macroeconomics is gone as far as local initiative is concerned and that is a good thing in a world where whenever the Banca d'Italia practices "independent monetary policy"; investors can't run fast enough. In this respect, the Euro is a thoroughly modern institution, well adapted to a highly integrated and trigger-happy world capital market.

- In the medium term, the Euro reinforces financial deregulation (national and cross border) in Europe to create a broad and deep capital market. Europe comes from a very dinky and segmented national and bank-based financial structure. It is on the way to a US-style capital market where households hold funds and companies issue paper and stocks; intermediation margins are small and governance significant. European companies will benefit from the transformation and it is likely to be the most significant supply side influence we will now see.

- There is no prospect of the Euro changing deeply and fast the world capital market in the sense that portfolio shifts will favor the Euro and that some alleged dollar privilege – remember General de Gaulle speaking of the exorbitant privilege, always a French obsession--. The Euro will not, per se, appreciate on the dollar just because it is the new kid on the block. In the labor market, Europe cannot afford a steep appreciation and that, for one, is why it won't happen. Central banks are well equipped to avoid the appreciation by offsetting open market operations and treasuries can reinforce it with their funding policies.

CURRENCY AND CAPITAL MARKET IMPLICATIONS

The introduction of the Euro leads to the immediate disappearance of 11 European currencies, including the Deutsche Mark, which surely had the status of a promising reserve asset and vehicle currency. There are immediate and important implications for both reserve management and debt management: new opportunities open up and traditional hedging strategies need to be reassessed.

Reserve Management:
Countries that peg exchange rates or wish to limit the extent of fluctuations of rates hold reserves to provide a cushion in case net external cash flow, on current and capital account, turns negative. Reserves are a substitute for adjustment when shocks are temporary and hence justify financing rather than adjustment. They also, in the case of persistent disturbances, help bridge until the appropriate adjustment can be accomplished. In a world where there is only a single outside currency, say the dollar; the only relevant issue is to determine the appropriate level of reserves. The determinants are likely to be, in addition to the scale of the economy, the volatility of net cash flows as well as the

opportunity cost of holding reserves as measured by the differential between the return on reserves and the cost of capital. The cost of disruptive adjustment or unwanted exchange rate movements certainly enters the optimal level of reserves.

But, of course, the world is not one of a single outside country and hence the question of how reserves are to be held is also a critical part of the discussion. Not surprisingly, the first pass at this question is to hold a diversified portfolio of reserves in various currencies where the portfolio shares represent the shares of the respective countries in the trade pattern. There is, accordingly, a sort of indexing where reserve holdings mirror trade patterns. The accompanying trade patterns of Latin America show that the dollar (not even including trading partners who peg the dollar) account for nearly half of Latin American trade. But, for the point of this discussion one might say "only" half of Latin American trade. What to do about the rest is an active question which, as we see below, is influenced by the arrival of the Euro.

Table 2 Western Hemisphere Trade Pattern (%)

	Exports To	Imports From
European Union	15.8	19.8
US	49.6	43.8

Source: IMF

But, first, note that for a number of reasons, this extensive indexation is in practice too cumbersome.

- Small partner countries' currencies or the currencies of countries with retarded or unstable capital markets are likely to have high transactions costs associated with the holding and management of a reserve position and therefore are replaced by a proxy currency. The costs of managing a reserve position system not only from bid-ask spreads and the costs of purchasing and holding securities but, importantly, also relate to the liquidity of the capital market in which reserves e held. Most countries have illiquid markets anytime, and more so when there is trouble, and hence most countries offer poor reserve vehicles. This leads naturally to the search for proxy vehicles. For example, Italy may be a significant trading partner but its imperfect capital market and high correlation with the DM makes the DM a good proxy currency to hold even for the Italian trade share. But the proxy role may be less than satisfactory when in fact the DM and the Lira are not perfectly correlated.

- The role of particular currencies in the reserve portfolio may be enhanced or reduced depending on any correlation they may have with the shocks the country is exposed to. Thus, for example, currencies that are strong when commodity prices are high will receive a larger weight in the reserve portfolio of countries that are commodity importers: a positive rice shock has a matching capital gain on reserves and thus helps in letting the reserve portfolio be a better hedge. To give another example, if interest rate shocks are important as is the case for a debtor country, the currency tat tends to strengthen when interest rate shocks occur would deserve an increase in its share beyond what trade patterns indicate.

In the past, with these general considerations in mind, countries have held their reserves predominantly in US dollars with a minor role played by the Ten and the DM. Where trade patterns with Britain were significant, some role for sterling existed, but it was pretty limited in the past decade. The dominant role of the dollar reflected, far beyond the trade role of the US, the proxy role. The US capital market has low transactions costs ands ample liquidity; it offers ideal reserve assets far beyond what could be had in Germany or Japan. Hence the dominant role of the dollar in central bank reserves.

The advent of the Euro, over time, will create a deep and liquid capital market in Europe. The very size of the market will attract competition, reduce spreads and hence offer holders of Euro-assets higher returns and better transactions potential. The Euro becomes, as a result, an equal to the US dollar as a reserve asset. It also becomes, more than the DM was in fact, a good proxy for Eastern Europe, the Middle East and more. In other words, reserve management enjoys the opportunity to come closer to target, enjoy higher returns and for a more diversified portfolio (in terns of risk exposure) still have a more liquid position that was possible before. All this because of the emergence of a European single capital market. That is surely the central effect and it implies that over time, as the capital market develops and becomes attractive, reserve holdings will shift from dollars (and Yen as Japan's public finance goes bankrupt and can no longer offer a hard currency and relatively riskless asset) toward the Euro. This is strongly reinforced by a number of peripheral countries in Europe's East adopting the Euro or shadowing the Euro. As a result, it would not at all be surprising, to see, say 5 or 10 years hence, as much as 40 percent of central bank reserves in Euros, up from a level of perhaps 20 percent today.

Debt Management:
What has been said about reserve management applies, of course, in the same way to debt management. A country has to decide how much public external debt it can and should carry and what is the optimal structure of maturity and currency denomination. Diversification of maturities and denomination is again appropriate. If a country's external non-debt cash flows are predominantly dollar denominated than of course dollar debt should be the dominant structure of liabilities. This avoids a situation, for example, where the dollar weakens and export revenues decline relative to the dollar value of debt service liabilities. Of course, countries will and should look at this indexing pattern of tailoring liabilities to cash flows of non-debt transactions in light of a risk and return

calculation. If Euros, for example, are available at longer maturities and lower interest rates that is superficially attractive. But it also carries the risk that the low interest rates, ex post, are offset by Euro appreciation and thus leave the borrower possibly much worse off. Worse, if excessive greed led the borrower be tempted into short maturities in a way not reflecting indexation, large and sudden external currency swings can create funding crises and as these emerge, roll-over becomes impossible and the actual crisis materializes. The message then is that the Euro does offer opportunities for diversification in funding but that looking for "bargains" – low interest rates on short maturities may, and often has, prove to be the worst possible avenue.

It is also the case, surely, that the emergence of a major European capital market, and the Euro denomination, does not create major new opportunities for access to capital for Latin America. True, the Belgian public, for example, may not have been interested in dollar debt of say Guatemala and Guatemala may not have been interested in issuing Belgian franc debt. But the two can meet on a common Euro ground which for the Belgians is the local habitat and for Guatemala, to some extent at least, is a plausible indexation denomination. Thus, some extra yes but not a lot because before the Euro the Belgians, and the Guatemalans, might have easily agreed on DM debt. The move from the DM to the Euro is real but not major.

CHANGING WORLD FINANCE

Reserve and debt management, to the extent that they depart from a narrow indexation pattern, involves speculation. It ids therefore appropriate to ask what can be expected of the stability or instability of currency rates among the dollar, the Yen and the Euro.
The first point to note is that, popular discussions notwithstanding, exchange rates have been quite stable.

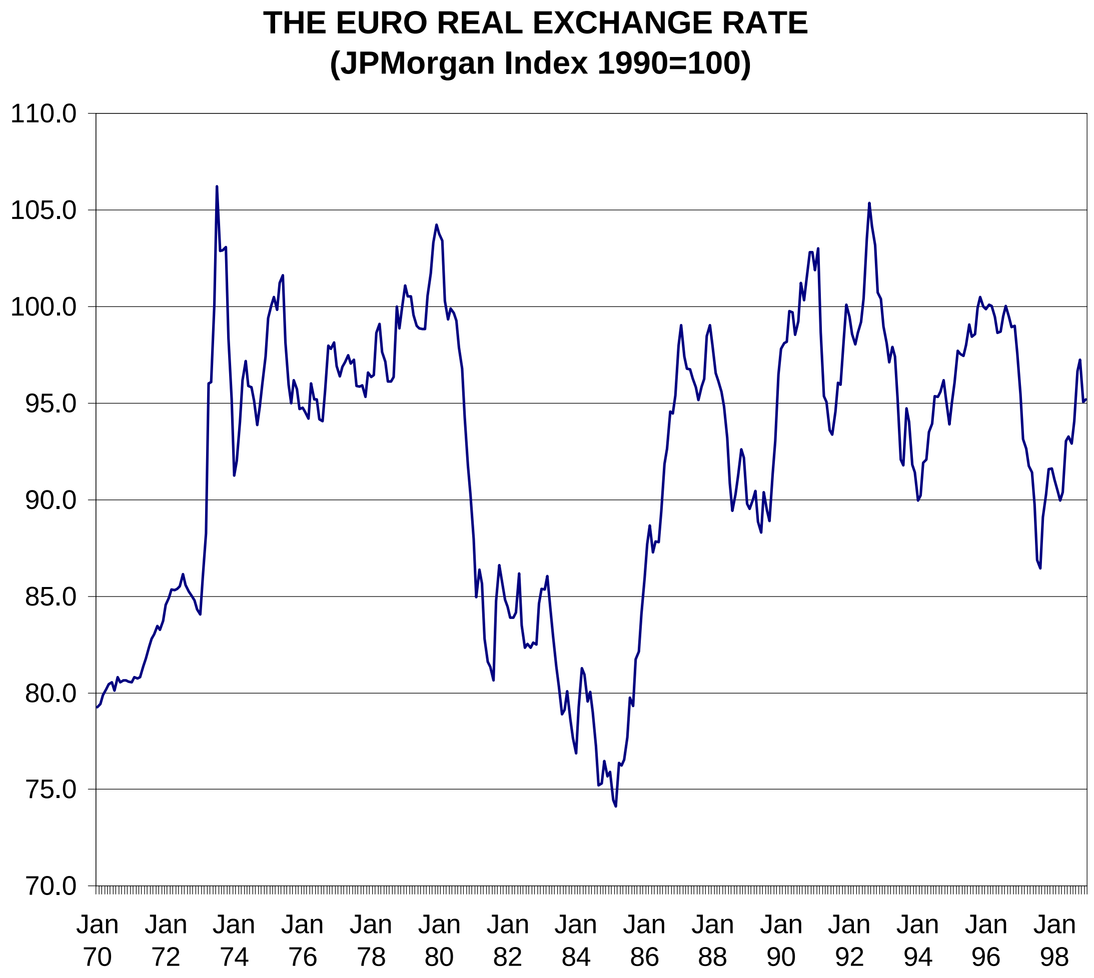
Table 3 Exchange Rate Variability

	1970-79	1980-89	1990-99
Yen/$	0.16	0.25	0.08
DM/$	0.22	0.21	0.12
Real Euro	0.08	0.09	0.04

Note: Variability is measured by the coefficient of variation.

That is true at least by comparison with the previous two decades. Next, note that the real exchange rate of the Euro has far less variability than the bilateral rates—say the DM/$

rate—and, again, has in the 1990s just half the variability of the past few years. It is important to recognize this stability to appreciate that there is no issue here of getting to international agreements to limit currency fluctuations. It is simply not an issue except for countries trying to deflect attention from their failure to deliver prosperity.



There are, of course, more fundamental reasons not to expect North Atlantic or Pacific target zones for key currencies. Effective target zones require policy coordination; they require that governments use monetary and/or fiscal policy to limit rate fluctuations even if the national interest would indicate using these instruments in the opposite direction. For example, if a weak US economy pushes down the dollar, target zones require raising interest rates. Fat chance! The US administration and the Congress, this and the next and the one after have no interest whatsoever in tying US prosperity to inexperienced and unsuccessful policy makers in Europe and Japan.

That is not to say complete and dogmatic benign neglect is the rule. We have seen effective instances of intervention when rates had become misaligned by all and any intervention. Whether the intervention was successful in and of itself or came at a point where the market was mostly ready to turn remains open. But the point is that with very substantial misalignments the same can be expected again. But more moderate movements of rates are certainly as possibility if not certainty. Exchange rate variability is here to stay if only because the various regions are rarely completely aligned in their cyclical situation and even less stay that way for any length of time.

There is no resumption at all that Latin America should be disappointed at the unwillingness of the US administration to entertain target zone ideas. Latin America, both in terms of its trade and liability patterns is predominantly keyed to the US. That creates a presumption that what is good for the US, including dollar appreciation or depreciation, is also beneficial for Latin America. There is most assuredly no case that Latin America has a far stronger interest in currency stability than the United States. For example, just like the US, Latin America has no interest in stability of the Euro-$ rate brought about by higher interest rates at a time of US cyclical weakness. On the contrary.

In another respect, however, we should expect change. The formation of the Euro is a first step in a worldwide tendency to have fewer independent monies. That tendency will accelerate in Europe as more and more of the left out countries—Greece, the UK, Denmark first and the entire East on to follow—join the Euro. They may do so with full membership or by explicitly shadowing the Euro with a fully committed peg possibly of the currency board scheme. The same is to be expected in Latin America where the discussion of dollarization is in fill swing after Argentina launched the debate. In Asia the issue is far harder because trade patterns are not concentrated on Japan and because Japan's miserable economic performance and increasing financial weakness make it a poor center currency.

EXCHANGE RATE STRATEGY ON THE PERIPHERY

In the aftermath of the Mexican and Asian crisis, and while the Brazilian debacle is still under way, lessons must be drawn for exchange rate strategy on the world's periphery. The lesson is obvious: Europe's periphery should adopt the Euro on a currency board basis or fully. And, in the same spirit, Latin America should follow the Argentine example of a currency board on the US dollar or outright dollarization. Tropical experiments have had their time on the stage; they should now give way to hard money as the single best development strategy.

National monies are, of course, an expression of nationalism and liberation on one hand and of a scope for macroeconomic policy to enhance economic performance on the other.

In a more limited and often abused fashion, they are a source of fiscal revenue. None of these reasons are plausible today. Open capital accounts have done away with independent interest rate setting, too much money printing has done away with money illusion, endemic inflation and devaluation policies (or catastrophes) have undermined economic horizons and the chances of sustained growth. The private sector has dollarized spontaneously to get away from the expropriation policies of their governments. In this sense, it is time to get back to an agenda of governance and that includes. As the top priority, solid money. Most emerging market economies cannot convince their residents or the capital market that their national institutions are capable of delivering good money on a sustained basis. Hence outsourcing money services by a currency board or full dollarization is the right strategy. The experience in Europe in many ways suggests the benefits Latin America can derive from such a strategy.

Over the past decade two developments have undermined the case for national central banking. First, we have experienced sharply increased international capital market integration and at the same time domestic financial deregulation. These developments have raised the cost of policy mistakes at the central bank. In fact, the cost of policy mistakes is far more catastrophic than earthquakes or other more traditional hazards. Second and closely related, the scope for monetary policy to create lasting employment benefits has been abused to the point of being wiped out. In one emerging country after another country, inflation has been rising to the point of extreme or even hyperinflation. *Having a central bank has become a liability.* The notion that a central bank could cut interest rates below that set by the ECB is just inconceivable. Rates are ECB+ national credit risk premium + national monetary experiments premium and the latter is huge. The world capital market, and domestic investors, charge high premia for the option to practice devaluation and inflation. That is counterproductive and hence a good central bank is a central bank that has been closed. *Unconditional, unilateral disarmament of the central bank is the first best option.*

Even if this point is recognized, it is difficult for countries to stomach the loss of national independence in literally abolishing is own central bank and adopting another country's money. How could Poland, for example, have accepted to use the Deutsche Mark? There was just far too much history. The creation of the Euro totally changes that environment in two ways. First, it demonstrates that individual countries can profitably surmount the prestige and pride in their own central bank and sign on to another one's policy—that us what the transition period was about that is what Italy or France decided to do in order to harvest the German credibility bonus. But the Euro also, of course, expresses the new *European monetary union and thus overcomes the objection of an unacceptable German monetary occupation area.

For countries that are desperately eager to become part and parcel of the European Union, over and beyond the transfer payments they hope to receive, there is here an immediate practical and unilateral step to be taken. Forsake bad money; adopt a currency board strategy that links the national money irrevocably to the Euro. As party of that commitment, and to make it automatic and irreversible change the central bank arrangements to make national credit creation by the central bank impossible and let money creation entirely be governed by the flow of foreign exchange. That s a radical step, but if it is recognized that any other strategy means taking financial risks. Thus it appears suddenly as the only sound one. It will translate shortly into a dramatic drop of inflation, an even larger drop in interest rates and the cost of capital. It would be a more powerful integrating device than the Euro is for the already-converged 1990s and Greece expects to achieve over the next few years.

All that is there to be had by the simple decision to give up independent central banking. Of course there are arguments against these. Two prominent ones are these: What happens if the monetary policy set by the ECB is bad? That is a serious concern for Germany, it is a joke to raise the issue in the case of say Poland or Hungary. And here is the other concern, how about the government revenue from money creation? With currency board discretionary money creation and the accompanying inflation are gone. True, but cutting record interest rates on the public debt and the savings on this account surely far more than outweigh the benefits of printing money.

Who might be the candidates for such a unilateral currency board arrangement. Surely the answer is all of Eastern Europe including the Balkans. And why not also Russia, Turkey and including North Africa. They all have a desperate need for a more sold financial linkage to the word; they all have substantial trade with Europe and want more integration. They all would stand to benefit looking at the example of Argentina where a currency board has been a centerpiece of a highly successful prosperity strategy. Spreading financial stability to the periphery would substantially leverage the benefits of the Euro and make Europe a far more powerful economic region over and beyond what it already has from sheer size and wealth.

It is not hard to grasp that a country like Poland would obviously gain from a Euro currency board. It could hardly muster an effective argument against it: seigniorage losses are outweighed by sharply lower debt service costs. Its national pride is enhanced by stability and growth rather than a sequence of debilitating and pathetic currency crises. Abortive attempts at exploiting money illusion no longer break the banking system and economic growth. All very obvious. But the same obviousness applies to Latin America. Which central bank in Latin America can deliver a money better than the Fed? And if there is none, what is the argument for countries to live with a worse quality monetary environment. We accept that free trade gives consumers better products at better prices and that there is no case for protection tat forces them to live with obsolete goods. In the same way we should think of money services.

There are, of course, a few technical issues that need to be addressed. The first is the fiscal requirements for a currency board. Next, is there not a need for a sound banking system before one has a currency board? Third, what happens to the lender of last resort? And also, are there enough reserves to start the project? Next, surely there is a loss of flexibility in terms of exchange rates and money. Finally, is the strategy ultimately not outright dangerous in the sense that Latin America is congenitally unable to stick to any commitment, i.e. the credibility issue? We comment on these in turn.

A currency board arrangement means two things: The exchange rate is irrevocably fixed and the central bank cannot issue money except in the context of foreign exchange purchases. It assuredly cannot finance the government. Thus, a currency board makes clear that any budget deficits must be financed in the capital market, domestic or foreign, and they cannot be financed by the central bank. There is a perfectly good capital market in the world and hence central bank financing is not necessary and it certainly is not desirable since the central bank uses the inflation tax and not some magic alternative source of revenue. If governments are credit worthy, deficits are perfectly compatible with a currency board. And if they are not, then making inflation is a bad answer to their predicament. In fact, as was surely the case in Argentina, a currency board focuses the mind on budget correction.

Consider next the banking issue. Stan Fischer of the IMF) has said that a currency board arrangement turns a balance of payments crisis into a banking crisis. True, capital flight will mean reserve losses, a shrinking of the monetary base, high interest rates and with that create market trouble. And if the banks are bad, high interest rates will cause casualties. But is that any different from what would happen in any other arrangement? If the central bank just pegs the rate it can for a while afford to lose reserves but after that either the exchange rate goes or the bank or most likely both. Asia is an example of just that. Small problems can be accommodated by reserve loss but they also will not create big banking problems under a currency board, big problems are just that and no exchange rate arrangement can shelter an economy and the worse the banks the larger the blow up. There is never a convenient time to clean up banks but, because bad banks get worse, the right time is immediately. A shift to a currency board may well provide the focus for dealing with this key issue.

Under a currency board, the central bank no longer can provide the lender of last resort function. What are the alternatives? The Treasury is the natural place to provide lender of last resort services. Failing that, offshore lenders can fill the gap. In fact, it would be thoroughly healthy system to require in exchange for a banking license a full external lender of last resort commitment. In that event the external stand-by lender would do the due diligence and monitoring that national authorities in emerging markets have so much trouble doing. Argentina has gone some steps in that direction, doing far more of this is a good idea. The notion that lender of last resort functions should be domestic is strange because most of the time the situation is one where capital flight puts both domestic money and domestic credit in question. Money can be created to bail out say the banks but only at the price of sending down the currency as happened in Russia.

The reserve coverage issue is important, indeed. The central bank must quite obviously be in a position to face a major shift out of domestic money. In 1995 for example, Argentina experienced an outward shift of one third of deposits. If reserves won't even cover the monetary base and not a significant portion of reserves, a currency board is likely to be tested early, interest rates will go to the sky and the central bank will close. But clearly there is absolutely no need to have 100 percent coverage of M2. A currency board that never-never fails, even if the country disappears is probably too stringent a test. Starting off with higher backing though clearly means more confidence, lower interest rates and hence a far better starting condition. That puts the focus on international institutions and the world capital market as the sources for funding currency boards with standby facilities. If they can find capital flight they must surely find themselves capable of funding stability instead.

The final question involves the endemic lack of credibility in many Latin American countries. Over and over again, governments try with overvalued currencies, the printing press and borrowing to deliver prosperity and sooner or later they fail. A currency board amounts to a commitment not to change the exchange rate and not to have uncovered issue of money. Who believes that the sheer discipline is there to do just that. Of course, Argentina is a case in point. Whether it is the disillusionment with having tried and failed with all other seeming options or the sheer success of the Convertibility Plan, nobody would go back. It would be surprising if, disillusioned as country now is, Brazil were not ready for just the same commitment to discipline. And note, if it is not a currency board then surely we have here another public debt that is on the way to default. Just as in Italy with the EMU, a currency board is in Brazil the easiest way to solve its public finance problem. And the same surely goes for Mexico where so much progress has been made and the benefits of much lower interest rates would complete the picture. People who argue that Latin America is incapable of discipline and therefore should stick with IMF + ad hocery do not give enough credit to the deep changes of a decade that now are asking for a more formal framework to harvest the benefits that come with it.

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